Introduction to Accounting

Concept Explanation:
Accounting is the language of business that records financial transactions in chronological order in the books of accounts. It focuses only on financial transactions related to the business.

Key Definitions / Features:
According to the American Institute of Certified Public Accountants, "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least of a financial character and interpreting the result thereof."

Accounting Process:

- Recording of financial transactions in the Journal (Journalizing)
- Recording in the Ledger (Posting to Ledger)
- Summarising the Activities / Transactions
- Analysis and Interpretation
- Communicating the results

Objectives of Accounting:

- Maintaining Records
- Estimating Profit or Loss
- Presenting the financial position
- Providing useful information to users

Advantages of Accounting:

- Availability of information
- Identifies strengths and weaknesses of business

- Enables comparison between time periods and similar companies
- Evidence in the court of law
- Payment of tax
- Helps in realisation of debts

Limitations of Accounting:

- Financial accounting is not absolutely exact
- Does not show the exact worth of business
- Problem of window dressing
- Worthless assets are often shown in the balance sheet
- No effect of inflationary trends
- Qualitative factors are ignored

Branches of Accounting:

- Financial accounting
- Cost accounting
- Management accounting

Types of Accounting Information:
Accounting information is generated through bookkeeping and includes financial statements such as the Income Statement (Profit and Loss Account) and the Position Statement (Balance Sheet). It can be categorised into:

- **Information Relating to Profit or Surplus:** Income Statement shows profit earned or loss incurred during an accounting period.
- **Information Relating to Financial Position:** Balance Sheet shows assets owned, amounts receivable, cash and bank balances, and liabilities such as loans and creditors.
- **Information about Cash Flow:** Cash Flow Statement shows inflow and outflow of cash during a specific period, aiding decisions like payment of liabilities and dividends.

Users of Accounting Information:

- **Internal Users:** Owners (to know return on investment and financial health), Management (to evaluate performance and make decisions)
- **External Users:** Investors (to ensure safety and growth of investments), Creditors (to assess financial capability), Lenders (to assess repayment capacity), Tax authorities (to assess taxes due), Others (customers, researchers)

Qualitative Characteristics of Accounting Information:

- **Reliability:** Information should be verifiable, free from errors and unbiased.

- **Relevance:** Information should be essential, appropriate, timely and avoid irrelevant data.
- **Understandability:** Information should be presented clearly for easy interpretation.
- **Comparability:** Enables comparison over time and between firms to assess growth and policy outcomes.

Role of Accounting in Business:
Accounting measures, summarises, analyses and communicates financial data to stakeholders. It is regarded as the language of business, providing quantitative financial information for decision-making. However, it relates only to past transactions and does not provide qualitative or non-financial information.

Basic Accounting Terms:

- **Entity:** A business with a definite individual existence for which accounting is done.
- **Business Transaction:** An activity involving exchange of money or money's worth that changes financial position; classified as cash or credit transactions.
- **Asset:** Properties owned by a business; classified as non-current (long-term use) and current (short-term use, convertible to cash within one year).
- **Liability:** Claims of creditors against the business; classified as current (to be paid within one year), non-current (long-term), and contingent (probable liabilities dependent on future events).
- **Capital:** Owner's investment; net worth of the business (Assets minus Liabilities); divided into fixed capital and working capital.
- **Drawings:** Withdrawal of cash or goods by owner for personal use; considered negative capital.
- **Revenue:** Increase in current assets without corresponding increase in liabilities or capital; inflow from main operations.
- **Goods:** Articles purchased for resale or use in manufacturing.
- **Stock / Inventories:** Goods unsold at a point in time; includes opening stock and closing stock; classified as raw materials, work-in-progress, and finished goods.
- **Purchases:** Goods bought for resale or conversion; excludes purchase of fixed assets.
- **Sales:** Sale of goods purchased for resale; includes cash and credit sales; excludes sale of assets.
- **Debtors:** Persons or firms to whom goods have been sold on credit and payment is pending.
- **Creditors:** Persons or firms to whom the business owes money for goods or expenses.

- **Profit:** Excess of sales over cost of goods sold from business operations.
- **Income:** Synonymous with profit; excess of total revenues over total expenses.
- **Gain:** Monetary benefit from transactions other than main operations.
- **Expense:** Amount spent to produce and sell goods and services; includes cost of goods sold and operating expenses.
- **Expenditure:** Amount spent to acquire fixed assets or increase earning capacity; classified as capital expenditure and revenue expenditure.
- **Loss:** Excess of expenses over revenues; includes normal losses (recurring) and abnormal losses (non-recurring due to extraordinary events).
- **Outstanding Expenses:** Expenses incurred but unpaid at the end of accounting period.
- **Prepaid Expenses:** Expenses paid in current year but relating to future periods.

Practice Set:

- *Level 1 – Easy:* Define accounting and list its main objectives.
- *Level 2 – Moderate:* Explain the difference between capital expenditure and revenue expenditure with examples.
- *Level 3 – Challenging:* Classify the following as asset, liability, capital, revenue, or expense: cash, loan from bank, owner's investment, rent paid, machinery purchase.

Answer Key:

- **Level 1:** Accounting is the art of recording, classifying and summarising financial transactions and interpreting the results. Objectives include maintaining records, estimating profit or loss, presenting financial position, and providing useful information.
- **Level 2:** Capital expenditure is spent on acquiring fixed assets for long-term use (e.g., buying machinery). Revenue expenditure is spent on day-to-day operations and benefits only the current period (e.g., rent, salaries).
- **Level 3:** Cash – Asset; Loan from bank – Liability; Owner's investment – Capital; Rent paid – Expense; Machinery purchase – Capital expenditure (Asset).

Quick Reference:

- Assets = Liabilities + Capital
- Working Capital = Current Assets – Current Liabilities
- Profit = Sales – Cost of Goods Sold

Glossary:

- **Asset:** Resource owned by business.

- **Liability:** Obligation to pay debts.
- **Capital:** Owner’s investment in business.
- **Revenue:** Income from main business operations.
- **Expense:** Cost incurred to earn revenue.
- **Drawings:** Owner’s withdrawal of assets.
- **Profit:** Excess of income over expenses.
- **Loss:** Excess of expenses over income.